

Message Text

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ACTION EUR-12

INFO OCT-01 ISO-00 FEA-01 AGRE-00 CEA-01 CIAE-00 COME-00
DODE-00 EB-07 FRB-03 H-01 INR-07 INT-05 L-03 LAB-04
NSAE-00 NSC-05 PA-01 AID-05 CIEP-01 SS-15 STR-04
ITC-01 TRSE-00 PRS-01 SP-02 OMB-01 PM-04 XMB-02
OPIC-03 SIL-01 IO-13 NSCE-00 SSO-00 USIE-00 INRE-00
/104 W

----- 018574 /14

O R 152339Z DEC 76
FM AMEMBASSY LONDON
TO SECSTATE WASHDC IMMEDIATE 8806
TREASURY DEPT WASHDC IMMEDIATE
INFO AMEMBASSY BONN
AMEMBASSY PARIS
AMEMBASSY ROME
USMISSION OECD PARIS
USMISSION EC BRUSSELS

C O N F I D E N T I A L SECTION 01 OF 02 LONDON 20294

DEPARTMENT PASS FEDERAL RESERVE BOARD

E.O. 11652: GDS
TAGS: EFIN, UK
SUBJECT: INITIAL EMBASSY COMMENTS ON THE CHANCEL-
LOR'S MINIBUDGET AND IMF LETTER

1. THE CHANCELLOR'S MINIBUDGET IN EFFECT COMPRISES
THREE PARTS: A) HIS ACTUAL PRESENTATION TO PARLIAMENT
B) THE TEXT OF THE UK LETTER OF APPLICATION TO THE
IMF
C) A TREASURY PRESS RELEASE SETTING FORTH ECONOMIC
PROSPECTS TO THE END OF 1977.

SEPARATE MESSAGES DEAL WITH EACH OF THESE IN CONSIDERABLE
DETAIL AND SHOULD BE READ IN CONNECTION WITH THIS REPORT.

2. THE CHANCELLOR WAS ON HIS FEET FOR 32 MINUTES IN WHAT
APPEARED A PARTICULARLY BOISTROUS -- SOMETIMES RAUCOUS --
HOUSE OF COMMONS. HIS PRESENTATION STRESSED THE CUTS IN
PUBLIC EXPENDITURE AND PSBR WITH A NOTE THAT DIRECT TAXES
WERE NOT BEING RAISED BECAUSE THEY ARE ALREADY TOO HIGH.
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AFTER GOING THROUGH THE BROAD DETAILS OF HIS PUBLIC

EXPENDITURE CUTS AND INCREASES IN EXCISE TAXES, HE CITED THE EMPLOYMENT SAVING ELEMENTS IN THE PROGRAM.

3. WILL THE CHANCELLOR'S PACKAGE ACHIEVE ITS PURPOSE? ON NARROW ECONOMIC GROUNDS, THE ANSWER IS PROBABLY YES. THE REDUCTIONS IN SPENDING, THE INCREASE IN EXCISE TAXATION, AND THE PROPOSED SALE OF BP SHARES WILL MAKE IT POSSIBLE TO REACH THE PSBR AND DCE TARGETS FLOWING FROM THE AGREEMENT WITH THE IMF. HOWEVER, THE PACKAGE IS ALSO INTENDED TO RESTORE CONFIDENCE -- THAT INTANGIBLE BUT INDISPENSIBLE ELEMENT -- AMONG BRITAIN'S FOREIGN CREDITORS BRITAIN'S INDUSTRIALISTS AND THE WIDER BRITISH PUBLIC. THAT CONFIDENCE DEPENDS IN LARGE PART ON THE BELIEF THAT HMG WOULD FINALLY TAKE THE HARD MEASURES (I.E., THOSE WHICH WOULD REDUCE PUBLIC SECTOR EMPLOYMENT).

4. IT IS VERY UNLIKELY THAT THERE WILL BE ANY SIGNIFICANT REDUCTION IN PUBLIC SECTOR EMPLOYMENT AS A RESULT OF THE PUBLIC EXPENDITURE SAVINGS. SOME MAY COME IN THE NEXT FISCAL YEAR FROM THE (IN MILLIONS OF POUNDS AT 1976 SURVEY PRICES) CUTS IN THE DEFENSE BUDGET (100) AND OVERSEAS AID (50). THE REDUCTIONS IN FOOD SUBSIDIES (160) AND REGIONAL EMPLOYMENT PREMIUM (150) ARE JUST THAT; I.E., REDUCTIONS IN SUBSIDIES WHICH, IF THEY HAVE AN IMPACT, WILL BE IN PRIVATE SECTOR EMPLOYMENT RATHER THAN FROM THE PUBLIC SECTOR. THE SAME IS TRUE IN REDUCTIONS IN ROAD CONSTRUCTION (75) AND LOCAL SECTOR CONSTRUCTION AND CAPITAL PROJECTS (50). THE SAVINGS FROM NATIONALIZED INDUSTRY REQUIREMENTS ON GOVERNMENT FINANCE (110) WOULD APPEAR TO BE SIMPLY SHIFTING THE BURDEN ON THE CONSUMER THROUGH HIGHER PRICES FOR NATIONALIZED INDUSTRY SERVICES -- WHICH INDEED IS APPROPRIATE -- BUT IT IS NOT A SHIFT IN RESOURCES AWAY FROM THE PUBLIC SECTOR. SHIFTING EXPORT CREDIT FINANCING TO THE BANKING SECTOR CAN BE VIEWED IN THE SAME VEIN, I.E. IN TERMS OF DEMANDS FOR RESOURCES IT APPEARS TO BE A BOOKKEEPING SHIFT RATHER THAN AN ACTUAL REDUCTION.

5. THE ECONOMIC PACKAGE WILL HAVE A DEFLATIONARY IMPACT WHICH WILL GIVE SOME AID TO THE BALANCE OF PAYMENTS AND WILL PROBABLY REDUCE REAL GDP BY 1/2 TO 2/3 OF A PERCENT-
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AGE POINT FROM WHAT IT WOULD HAVE BEEN IN FY1977. THE REDUCTION IN SUBSIDIES AND INCREASE IN TAXES WILL REDUCE DISPOSABLE INCOME AND CONSEQUENTLY AGGREGATE DEMAND FOR GOODS AND SERVICES. THE REDUCED PUBLIC SECTOR BORROWING REQUIREMENT SHOULD CONTRIBUTE SUBSTANTIALLY TO CONTROLLING THE GROWTH OF THE MONEY SUPPLY. THESE EFFECTS WILL NATURALLY RESTRICT THE DEMAND FOR IMPORTS OF CONSUMPTION AND INVESTMENT GOODS AS WELL AS NEW MATERIALS. THE

OFFICIAL FORECAST (SEE SEPTTEL) OF 8-1/2 PERCENT EXPORT
GROWTH IN SECOND HALF 1977 OVER SECOND HALF 1976
AND IMPORTS IN THE SAME PERIOD INCREASING ONLY 1-1/2 PER-
CENT MUST BE VIEWED CRITICALLY.

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----- 018735 /14

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6. THE MEASURES DO NOT IN THEMSELVES ACHIEVE THE STRUC-
TURAL SHIFT THAT WOULD GIVE THE UK LONG TERM ECONOMIC
IMPROVEMENT. IN PARTICULAR THE PUBLIC SECTOR'S USE OF
RESOURCES WILL BE MAINTAINED, LEAVING THE PRIVATE SECTOR
TO TAKE UP THE BRUNT OF THE DEFLATIONARY ADJUSTMENT--
IN PARTICULAR THE BRUNT OF UNEMPLOYMENT .

7. WHEN DISCUSSING THE AMOUNTS THAT WOULD BE
MADE AVAILABLE FROM THE IMF("\$1.15 BILLION IMMEDIATELY
AND OVER \$1 BILLION MORE BEFORE THE END OF 1977") AND IN
CITING THE US TREASURY-FED \$500 MILLION SWAP LINE AND
THE BUNDESBANK \$350 MILLION STANDBY, HEALEY DID HIS
BEST TO GIVE THE IMPRESSION THIS WAS AN ENDORSEMENT OF

HIS POLICIES BY THE INTERNATIONAL FINANCIAL COMMUNITY:

"THE ENDORSEMENT OF OUR POLICIES BY THE INTERNATIONAL MONETARY FUND AND THE MEMBERS OF THE GAB WILL RELIEVE THE PRESSURES ON STERLING WHICH HAVE DAMAGED OUR ECONOMIC PROSPECTS IN THE LAST 12 MONTHS WHILE THE PROSPECTIVE ARRANGEMENT FOR THE STERLING BALANCES WILL HELP TO RE-
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DUCE THE RISK OF SUCH PRESSURES IN FUTURE YEARS. THIS SHOULD DO MUCH TO RESTORE THE CONFIDENCE ON WHICH ALL ASPECTS OF OUR ECONOMIC PERFORMANCE CRITICALLY DEPEND."

8. THE INITIAL OPPOSITION REACTION EXPRESSED BY SHADOW CHANCELLOR SIR GEOFFREY HOWE WAS THAT THIS IS AN IMF BUDGET IMPOSED BY THE IMF AND WHICH WILL BE MONITORED BY THE IMF. OPERATORS IN BOTH GILT-EDGED AND FOREIGN EXCHANGE MARKETS ARE MUCH MORE CRITICAL. ESPECIALLY ON THE FAILURE TO TACKLE WHAT THEY CONSIDER TO BE OVEREMPLOYMENT IN THE PUBLIC SECTOR.

9. STERLING DROPPED 2 CENTS FROM ROUGHLY \$L.6850 TO \$1.6650 ON THE STRENGTH OF THE CHANCELLOR'S PRONOUNCEMENT. SELLING WAS NOT ESPECIALLY HEAVY AND MUCH OF IT APPEARED CONCENTRATED IN LONDON WHERE UK BANKERS WHO HAD TAKEN LONG POSITIONS IN THE MORNING WERE DISAPPOINTED BY THE CONTENT OF THE PACKAGE AND THEREFORE WERE SEEN TO BE REVERSING POSITIONS. MOST CRITICAL REACTION FOCUSED ON THE FAILURE TO REDUCE PUBLIC EXPENDITURE IN OTHER AREAS RATHER THAN IN REDUCTION OF PSBR. SENIOR TRADER IN A MAJOR CLEARING BANK SUMMED UP VIEWS HEARD REFLECTING THE FOREIGN EXCHANGE MARKET'S DISAPPOINTMENT BY SAYING THE "CHANCELLOR HAD ONCE AGAIN FAILED TO GRASP THE NETTLE AND ONCE AGAIN COME IN WITH TOO LITTLE TOO LATE." ONE BANKER WAS SURPRISED THE UK COULD ARRANGE AN IMF LOAN ON SUCH EASY CONDITIONS, ADDING THAT IT WAS NOT THE SORT OF PACKAGE THAT WOULD CAUSE THE POUND TO APPRECIATE.

10. WHAT IS BEING INITIALLY PERCEIVED IN THE MARKET AND AMONG ECONOMIC COMMENTATORS IS THAT DOMESTIC POLITICAL IMPERATIVES SEEM TO HAVE ONCE AGAIN PREVENTED A PROGRAM SUFFICIENTLY TOUGH TO CONVINCE THE WORLD THAT THE NEEDED STRUCTURAL CHANGES ARE FINALLY UNDERWAY. THIS VIEW, HOWEVER, WILL NOT BE ENTIRELY SHARED BY TUC LEADERS AND THE LEFT WING OF THE PARLIAMENTARY LABOR PARTY. WHO HAVE ALREADY COMPLAINED ABOUT LOSS OF SOVEREIGNTY TO THE IMF.

11. THE CHANCELLOR HAS ONCE AGAIN PRODUCED A PACKAGE WHICH PLEASES NO ONE, NEITHER THE LEFT WING OF HIS PARTY NOR THE OPPOSITION NOR THE MARKETS. HE OBVIOUSLY WENT TO
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GREAT PAINS TO BE ABLE TO DEMONSTRATE HE HAD NOT INCREASED UNEMPLOYMENT, AT LEAST NOT IN THE PUBLIC SECTOR. ON REFLECTION, THE MARKETS MAY TAKE A MORE FAVORABLE ATTITUDE GIVEN THE LONGER TERM ELEMENTS IN THE PROGRAM. FOR THE MOMENT, THEY REMAIN TO BE CONVINCED BY A PACKAGE WHICH APPEARS DESPITE THE FIRE AND BRIMSTONE AND CABINET BATTLES TO BE THE ABSOLUTE MINIMUM NECESSARY TO OBTAIN IMF ACQUIESCENCE.

12. OTHER MESSAGES IN THIS SERIES INCLUDE UK LETTER OF INTENT TO IMF (LONDON 20283); EXPORT CREDIT IN THE MINIBUDGET (LONDON 20291); ECONOMIC PROSPECTS TO END 1977 (LONDON 20292); AND HIGHLIGHTS OF THE CHANCELLOR'S MINIBUDGET PRESENTATION TO PARLIAMENT (LONDON 20293).

ARMSTRONG

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Message Attributes

Automatic Decaptioning: X
Capture Date: 01 JAN 1994
Channel Indicators: n/a
Current Classification: UNCLASSIFIED
Concepts: GOVERNMENT BUDGET, CENTRAL LEGISLATURE, ANTIINFLATIONARY PROGRAMS, ECONOMIC CONTROLS, ECONOMIC DATA
Control Number: n/a
Copy: SINGLE
Draft Date: 15 DEC 1976
Decaption Date: 01 JAN 1960
Decaption Note:
Disposition Action: RELEASED
Disposition Approved on Date:
Disposition Authority: GolinoFR
Disposition Case Number: n/a
Disposition Comment: 25 YEAR REVIEW
Disposition Date: 28 MAY 2004
Disposition Event:
Disposition History: n/a
Disposition Reason:
Disposition Remarks:
Document Number: 1976LONDON20294
Document Source: CORE
Document Unique ID: 00
Drafter: n/a
Enclosure: n/a
Executive Order: GS
Errors: N/A
Film Number: D760462-0389
From: LONDON
Handling Restrictions: n/a
Image Path:
ISecure: 1
Legacy Key: link1976/newtext/t19761241/aaaabjjq.tel
Line Count: 244
Locator: TEXT ON-LINE, ON MICROFILM
Office: ACTION EUR
Original Classification: CONFIDENTIAL
Original Handling Restrictions: n/a
Original Previous Classification: n/a
Original Previous Handling Restrictions: n/a
Page Count: 5
Previous Channel Indicators: n/a
Previous Classification: CONFIDENTIAL
Previous Handling Restrictions: n/a
Reference: n/a
Review Action: RELEASED, APPROVED
Review Authority: GolinoFR
Review Comment: n/a
Review Content Flags:
Review Date: 06 APR 2004
Review Event:
Review Exemptions: n/a
Review History: RELEASED <06 APR 2004 by ShawDG>; APPROVED <07 APR 2004 by GolinoFR>
Review Markings:

Margaret P. Grafeld
Declassified/Released
US Department of State
EO Systematic Review
04 MAY 2006

Review Media Identifier:
Review Referrals: n/a
Review Release Date: n/a
Review Release Event: n/a
Review Transfer Date:
Review Withdrawn Fields: n/a
Secure: OPEN
Status: NATIVE
Subject: INITIAL EMBASSY COMMENTS ON THE CHANCEL- LOR'S MINIBUDGET AND IMF LETTER
TAGS: EFIN, UK
To: STATE TRSY
Type: TE
Markings: Margaret P. Grafeld Declassified/Released US Department of State EO Systematic Review 04 MAY 2006